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Illustrations of accounting for in substance defeasance of debt: a survey of the application of FASB statement no. 76; Financial report survey, 32

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FINANCIAL REPORT SURVEY 32

Illustrations of Accounting for in Substance Defeasance of Debt

A survey of the application of FASB Statement No. 76

By Hortense Goodman, CPA
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*OUT OF PRINT

Illustrations of Accounting for in Substance Defeasance of Debt

A survey of the application of FASB Statement No. 76

Illustrations of Accounting for in Substance Defeasance of Debt

A survey of the application of FASB Statement No. 76

by HORTENSE GOODMAN, CPA
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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

NOTICE TO READERS

This is a publication of the staff of the American Institute of Certified Public Accountants and is not to be regarded as an official pronouncement of the Institute.

PREFACE

This publication is the thirty-second in a series produced by the Institute's staff through use of the Institute's National Automated Accounting Research System (NAARS). Earlier publications in the series are listed on the inside cover of this publication.

The purpose of the series is to provide interested readers with examples of the application of technical pronouncements. It is believed that those who are confronted with problems in the application of pronouncements can benefit from seeing how others apply them in practice.

It is the intention to publish periodically similar compilations of information of current interest dealing with aspects of financial reporting.

The examples presented were selected from over twenty thousand annual reports stored in the NAARS computer data base.

This compilation presents only a limited number of examples and is not intended to encompass all aspects of the application of the pronouncements covered in this survey. Individuals with special application problems not illustrated in the survey may arrange for special computer searches of the NAARS data banks by contacting the Institute.

The views expressed are solely those of the staff.

John Graves
Director, Technical Information Division

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I

SCOPE AND PURPOSE OF THE SURVEY

FASB STATEMENT NO. 76

A business enterprise may extinguish debt early in several ways, of which one way—in substance defeasance—is discussed in FASB Statement No. 76, "Extinguishment of Debt" (see Appendix). An enterprise in substance defeases debt by establishing a fund with the characteristics specified in paragraph 4 of Statement No. 76. If such a fund is established, the Statement requires the debt and the fund to be eliminated from the financial statements, which usually involves recognizing a gain or loss.

In addition, FASB Technical Bulletin No. 84-4, "In-Substance Defeasance of Debt," issued October 17, 1984, and effective for debt incurred on or after September 12, 1984, provides guidance for applying FASB Statement No. 76 to in substance defeasance transactions. It prohibits instantaneous in substance defeasance transactions of the type illustrated on page 6, under the heading "Foreign Currency Denominated Debt," which relate to debt incurred before the effective date of the bulletin. The bulletin also discusses assessing remoteness of risk of trust assets and in substance defeasance of callable debt.

FASB Statement No. 4, "Reporting Gains and Losses from Extinguishment of Debt," paragraph 8, requires gains and losses on all kinds of early extinguishments of debt to be classified as Extraordinary Items except for gains and losses "from cash purchases of debt made to satisfy current or future sinking fund requirements." Under that requirement, some gains and losses resulting from in substance defeasances of debt are classifiable as Extraordinary Items.

SOURCE OF ILLUSTRATIONS

Deciding on whether debt has been in substance defeased and accounting for an in substance defeasance in accordance with FASB Statement No. 76 require considerable judgment. An accountant who is confronted with problems in applying the Statement can benefit from learning how other accountants are applying it in practice. Accordingly, this publication presents forty excerpts from recently published financial statements that illustrate its apparent application.

The AICPA National Automated Accounting Research System (NAARS) was used to compile the information for the present survey. The examples presented were selected from more than 20,000 published annual reports to shareholders stored in the computer data base.

II

PRESENTATION OF THE EXAMPLES

Forty examples of accounting for in substance defeasances of debt are presented below. The examples are classified by the kinds of liabilities that were in substance defeased.

In three examples, the debt for which a fund was established was denominated in foreign money, and foreign government securities were put in the fund. Treating the debt as extinguished seems to be in keeping with the spirit of FASB Statement No. 76 although it does not discuss the use of foreign government securities for in substance defeasance.

Court Judgement

AMPCO-PITTSBURGH CORPORATION
Notes to Financial Statements

Note 4—Extinguishment of Debt:

In connection with the acquisition of Buffalo Forge Company ("BFC") in 1981, a controversy developed with Ogden Corporation over its interest, by purchase and option, in 568,400 shares of BFC treasury stock (the "Contested Shares") it acquired during the Corporation's tender offer for BFC. This matter was finally adjudicated in favor of Ogden in 1983. As the Corporation recorded the contested liability in 1981, there was no material adverse effect on the Corporation's financial statements as a result of this litigation.

On December 29, 1983 the Corporation established an irrevocable trust for the extinguishment of the liability for Contested Shares in the amount of $22,048,542 which was sufficient to satisfy the judgment including net interest thereon. Payment to Ogden was made on January 11, 1984 by the trust in full satisfaction of the court judgment.

Debentures

MARINE MIDLAND BANKS, INC.
Notes to Financial Statements

Note 9. Long-Term Debt

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The 5% debentures due 1989, the 8⅛% debentures due 1994 and the 7⅝% debentures due 2003, although outstanding, are considered extinguished for financial reporting purposes since in 1984 U.S. Government securities were placed in an irrevocable trust solely for the purposes of making interest payments and of retiring the debentures as they become due. Accordingly, the securities and the debentures do not appear in the balance sheet at December 31, 1984. See Note 13, Extraordinary Item.

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Note 13. Extraordinary Item

In 1984, the Corporation placed U.S. Government securities with a market value of $118,263,000 in an irrevocable trust. Income and principal on these securities received by the trust will be used solely for the purpose of making required interest payments on the $49,468,000 of 5% debentures due 1989, the $51,139,000 of 8⅛% debentures due 1994, and the $49,100,000 of 7⅝% debentures due 2003 and to retire the issues as they become due. Accordingly, the debentures are considered to be extinguished for financial reporting purposes in 1984 and the securities and the debentures do not appear in the balance sheet at December 31, 1984. The transaction resulted in an extraordinary gain of $16,035,000 (net of related income tax of $17,709,000). See Note 9, Long-Term Debt.

SHELL OIL COMPANY
Notes to Financial Statements

7. Long-Term Debt

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In both 1984 and 1983, the Company purchased U.S. government securities and deposited them in irrevocable trusts. The principal and interest from these securities is sufficient to fund the scheduled principal and interest payments on certain portions of the Company's long-term debt. Government securities were acquired at a cost of $184 million in 1984 and $90 million in 1983 and were used to fund portions of certain Company debentures in the principal amount of $243 million in 1984 and $146 million of pollution control obligations in 1983. These government securities and long-term debt issues were removed from the balance sheet, and after related expenses including provisions for income taxes were recognized, $38 million in 1984 and $34 million in 1983 were recorded in income. At December 31, 1984, $389 million of such debt remained outstanding.

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URS CORPORATION
Notes to Financial Statements

Note 8—Notes Payable and Long-Term Debt

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In January 1983, a supplemental indenture modified certain covenants and suspended certain dividend and distribution restrictions with respect to the debentures due in 1987 and 1992. In connection with the modification of the covenants, the Company maintains a $5 million letter of credit in favor of the trustee. This debt was extinguished in 1984 through the creation of an irrevocable trust containing risk free securities. There was no significant gain or loss.

● ● ● ●

UAL, INC.

Statements of Consolidated Earnings

(In Thousands, Except Per Share)	Year ended December 31 1984	1983	1982

• • • •

Extraordinary Item:

Gain on defeasances of debt and obligation under capital lease in 1984 and gain on purchase of notes in 1982, less provision for deferred income taxes of $20,300,000 in 1984 and $16,800,000 in 1982	21,513	—	19,812

• • • •

Statements of Changes in Consolidated Financial Position

(In Thousands)	Year ended December 31 1984	1983	1982

• • • •

Funds provided from (used by) financing activities:

Extraordinary item—gain on defeasances of debt and obligation under capital lease in 1984 and gain on purchase of notes in 1982, less provision for income taxes	21,513	—	19,812

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Notes to Financial Statements

Long-Term Debt

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UAL and United completed "in-substance defeasances" of the entire $47,225,000 principal amount of their outstanding 5% and 4¼% subordinated debentures and 6½% and 7½% notes in January and February 1984, and United completed an "insubstance defeasance" of $37,958,000 principal amount of its outstanding 8¼% secured notes in October 1984. United and a municipal corporation completed a legal defeasance of $73,065,000 principal amount of certain outstanding municipal airport improvement bonds in June 1984. These defeasances, which were accomplished by irrevocably placing U.S. Government obligations in trusts to be used solely for satisfying scheduled payments of both interest and principal of the respective debt, resulted in a UAL consolidated extraordinary gain of $21,513,000, or $.62 per share (primary), after deducting a $20,300,000 provision for deferred income taxes, for the year 1984.

During 1982, $173,356,000 principal amount of United's outstanding 6½% and 7½% notes was purchased for $138,389,000 and an additional $12,480,000 principal amount was legally defeased for $10,835,000, resulting in a consolidated extraordinary gain of $19,812,000, after deducting a $16,800,000 provision for deferred federal income tax.

As of December 31, 1984, the total principal amount of indebtedness that is considered to be extinguished under "insubstance defeasances," and therefore excluded from consolidated long-term debt, was $81,194,000.

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Foreign Currency Denominated Debt

BAXTER TRAVENOL LABORATORIES, INC.
Notes to Financial Statements

Long-Term Debt and Lease Obligations

• • • •

In February, 1984, a wholly owned subsidiary of the company issued 200,000,000 Deutsche Mark ("DM") 7.25% bonds due in 1994, which are guaranteed by the company. The proceeds were used to purchase an approximate equivalent amount of German government securities maturing in 1994, yielding 8.25%. In September, 1984, the company extinguished the DM bonds (approximately $65,700,000) through an in-substance defeasance. This in-substance defeasance was accomplished by placing the German government securities in an irrevocable trust from which principal and interest payments will be made on the DM bonds. The company recognized a gain of $800,000 after taxes from this transaction.

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PEPSICO, INC.
Notes to Financial Statements

Note 5/Notes Payable and Long-term Debt

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During 1984, PepsiCo issued $104 million of Deutsche mark denominated bearer bonds yielding 7-1/4 percent, due February 26, 1994. A major portion of the bond proceeds were used to purchase higher yielding notes of the West German Government that yield cash flows sufficient to meet the interest and principal payments of the bearer bonds. PepsiCo defeased the bonds by depositing the Deutsche mark denominated government notes in an irrevocable trust established for the sole purpose of servicing the bearer bonds. This defeasance resulted in a $1.7 million ($.02 per share) gain, after related expenses and taxes. The bearer bonds and promissory notes of the West German Government offset each other in the Consolidated Balance Sheet.

STERLING DRUG, INC.
Notes to Financial Statements

Debt

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In the second quarter of 1984, a subsidiary of the company issued $92.7 million of West German mark 7¼% bearer bonds due March 1994. A major portion of the proceeds from these bonds was used to purchase West German government mark securities which were deposited in an irrevocable trust in an amount sufficient to fund the principal and interest payments on the company's debt. The company realized a gain after expenses of $2,185,000; the after-tax income was $1,179,000, or $.02 per share. This transaction was an in-substance defeasance and, therefore, the West German mark debt and government securities are not reflected on the balance sheet.

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Industrial Revenue Bonds

REYNOLDS METALS COMPANY
Notes to Financial Statements

Note E—Long-Term Debt (excluding convertible subordinated debentures)

• • • •

During 1983 the company borrowed $41.3 million through the issuance of Adjustable Rate Industrial Revenue Bonds (fixed at 7½% for five years) due 2013. The net proceeds of the borrowing were used to purchase U.S. Treasury securities to be held in an irrevocable trust to satisfy debt requirements of $40 million of 10¾% Industrial Revenue Bonds due 1986, which have been considered retired.

RUDDICK CORPORATION
Notes to Financial Statements

Long-Term Debt

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During 1984, the outstanding principal balance ($1,775,000) of the Milledgeville-Baldwin County Industrial Revenue Bonds was defeased and is now secured by general and direct obligations of the United States of America.

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VAN DORN COMPANY
Notes to Financial Statements

(5) Leased Assets and Lease Commitments

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In 1978, the Company sold its Fort Madison, Iowa, can producing facility. The facility, which was recorded as a capitalized lease, was financed by City of Fort Madison, Iowa, Industrial Revenue Bonds. In connection with the sale, the Company deposited in an irrevocable trust an amount sufficient to repay the principal and interest on the bonds as they become due. Accordingly, the amount of the deposit and the unpaid balance of the bonds are not included in the accompanying balance sheets. The unpaid principal balance of the bonds was $455,000 at December 31, 1984.

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Leases (Capital)

CLUETT, PEABODY & CO., INC.
Notes to Financial Statements

11. Leases.

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During 1984, the Company contributed U.S. government securities to irrevocable trusts which effectively extinguished certain capital lease obligations having a present value of $5,925,000, resulting in a pre-tax gain of $2,167,000.

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DEKALB AgResearch, INC.
Notes to Financial Statements

I. Long-Term Debt

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The company, as permitted by the applicable indentures, extinguished eight outstanding issues of capitalized leases in the amount of $20.4 million during the year ended August 31, 1983, by depositing U.S. government securities with the indenture trustees for defeasance of the respective issues. Earnings during the year ended August 31, 1983, include a gain (net of applicable income taxes of $2.4 million) of $2.4 million ($.19 per share).

• • • •

DEPOSIT GUARANTY CORP.
Notes to Financial Statements

Note 6—Leases

On September 18, 1984, the Bank realized an extraordinary gain, net of applicable deferred income taxes, of $2,097,000 as a result of the defeasance of the Deposit Guaranty Plaza building (DG Plaza) capital lease. The capital lease obligation was satisfied prior to its maturity date by transferring certain U.S. Government interest coupons to a trust account, the proceeds of which will be used to retire the capital lease obligation. The amount of capital lease obligation extinguished at December 31, 1984 was $14,696,000. At December 31, 1984 and 1983, $15,950,000 has been included in buildings and leasehold improvements under the defeased capital lease. Accumulated amortization of $4,444,000 at December 31, 1984 and $3,988,000 at December 31,1983 was included in accumulated depreciation and amortization.

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MORRISON INCORPORATED
Notes to Financial Statements

6. Long-Term Debt

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At June 1, 1985 and June 2, 1984, $3,000,000 of long-term debt was considered extinguished in accordance with Statement of Financial Accounting Standards No. 76 concerning in-substance defeasance of corporate debt. U.S. Treasury Bills and cash have been placed in an irrevocable trust to satisfy scheduled payments of both interest and principal on these defeased debt obligations.

11. Leases

• • • •

At June 1, 1985 and June 2, 1984, respectively, $5,295,000 and $5,650,000 of capital lease obligations are considered extinguished in accordance with Statement of Financial Accounting Standards No. 76 concerning in-substance defeasance of corporate debt. U.S. Treasury Bills and cash have been placed in an irrevocable trust to satisfy scheduled payments of both interest and principal on these capital lease obligations.

PENN VIRGINIA CORPORATION
Notes to Financial Statements

5. Long-Term Debt

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During September 1984, most of the proceeds from the sale/leaseback transaction were used to enter into an "in substance" defeasance of the Vibranetics, Inc. capital lease (with a remaining balance outstanding of $3,664,000). This was accomplished through the placement of U.S. Government securities costing $3,144,798 in an irrevocable trust, resulting in a pre-tax gain of $519,202. The amount of debt considered extinguished at December 31, 1984 was $3,330,000.

THE WESTERN COMPANY OF NORTH AMERICA
Notes to Financial Statements

Note 3—Long-Term Debt

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Extraordinary Gain—In 1984 the Company extinguished a portion of the debt related to ship financing bonds and to certain offshore drilling rig capital lease obligations, resulting in an extraordinary gain of $1,803,000 ($.04 per common share), net of applicable income taxes of $183,000. The debt extinguishment was effected through an in-substance defeasance as provided in Statement of Financial Accounting Standards No. 76, "Extinguishment of Debt." The defeasance was accomplished by irrevocably dedicating $7,966,000 of U.S. Government and U.S. Government-backed securities to the satisfaction of future principal and interest payments related to the bonds and capital lease obligations defeased. Funds used in the defeasance were obtained from MarAd escrow funds. At December 31,1984, the amount of bonds and capital lease obligations considered extinguished was $8,964,000.

Note 4—Capital Leases

Capital leases pertain to offshore drilling rigs, petroleum services equipment and an aircraft. During 1973 through 1975 three offshore drilling rigs were leased for fifteen-year periods. The Company has options to purchase these rigs at amounts substantially equivalent to their fair market value at the date options are exercised. In 1984 a portion of capital lease obligations related to these rig leases was defeased as discussed in Note 3. The Company has entered into similar seven to nine-year lease agreements with respect to specialized petroleum services equipment. In 1981 and 1982 the Company leased an aircraft and an offshore drilling rig for twelve-year periods, after which each may be purchased for a nominal amount. These lease agreements have restrictions and covenants similar to those discussed in Note 3.

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Loan

MERRILL LYNCH & CO., INC.
Notes to Financial Statements

Long-Term Borrowings

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At December 28, 1984, $17,000,000 of a 7⅞% loan due 2003 remained outstanding. The loan was funded by establishing an irrevocable trust and depositing in the trust sufficient U.S. Government securities to satisfy all future principal and interest payments. Neither the loan nor the Government securities in trust are reflected on the balance sheet in 1984 or 1983.

• • • •

Mortgages

BANCO DE PONCE
Statements of Changes in Financial Position

	Years ended December 31, 1984	1983
• • • •		
Funds used:		
• • • •		
In-substance defeasance of mortgage note (in 1984) and other repayments	12,353,669	244,202
• • • •		

Notes to Financial Statements

(8) Mortgage Notes Payable

In 1983 mortgage notes payable represents mainly the mortgage note payable related to the San Juan metropolitan area headquarters building. This note is payable in quarterly installments of $315,700 through 1993 and $457,669 thereafter to 1999, including interest at 8-1/4%, and is secured by a first mortgage on the building which has a carrying value of $11,758,000 at December 31, 1984. On April 5, 1984, the Bank extinguished the aforementioned mortgage note payable through an "in-substance defeasance" transaction by acquiring U.S. Treasury Notes at a cost of $9,761,185 ($23,127,625 par value) and placing such securities in an irrevocable trust to fund all future scheduled payments of both interest and principal on the note. The net gain from the transaction is reported as an extraordinary income of $2,488,459 ($1.55 per share) in the accompanying statements of earnings. The mortgage note payable with an outstanding balance of $12,088,082 at December 31, 1984 is considered extinguished under generally accepted accounting principles.

DUKE POWER COMPANY
Notes to Financial Statements

Note 12 Long-Term Debt

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On October 2, 1984, the Company transferred certain U.S. government securities to an irrevocable trust for the defeasance of $32,850,000 of its 14⅜ percent first and refunding mortgage bonds. The cash flow from this trust will be sufficient to fund the scheduled principal and interest payments on these bonds. Accordingly, in 1984 this amount was removed from the balance sheet. The entire series of 14⅜ percent bonds will be retired on March 1, 1985.

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EASTERN UTILITIES ASSOCIATES
Notes to Financial Statements

(F) Long-Term Debt:

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Eastern Edison has accounted for the early extinguishment of a series of its First Mortgage and Collateral Trust Bonds due in 1985 by placing the funds necessary to satisfy all debt requirements of the Bonds in an irrevocable Trust in accordance with Statement of Financial Accounting Standards No. 76.

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FIRST NATIONWIDE FINANCIAL CORPORATION
Notes to Financial Statements

Note G
Federal Home Loan Bank Advances, and Notes, Bonds and Other Obligations

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In July 1979, First Nationwide Savings issued $75,000,000 of 9½% ten-year bonds, secured by mortgages, in a public offering at a discount of $694,000. The indenture for the bonds generally required that the Association maintain with the trustee Eligible Mortgage Notes and Government Securities (as defined) with a value on a discounted basis of not less than 150% of the principal amount of bonds. At December 31, 1983, the principal amount of the bonds totalled $39,829,000 with a discount of $190,157. The bonds were secured by $173,260,000 of mortgage loans with a discounted value of approximately $132,236,000. The discounted value of the unpaid principal balance of the loans securing the bonds was well in excess of the 150% requirement because the bonds had been retired more rapidly than the indenture allows for the release of the collateral. On December 31, 1984 the Association placed into trust approximately $36 million worth of cash and United States Treasury securities with serial maturity dates matching the Association's interest and principal payment obligations under the indenture of Trust pursuant to which the Series A Mortgage-Backed Bonds were issued and sold. The trustee will pay the proceeds of the maturing securities directly to the bond trustee for the holders of the Series A Mortgage-Backed Bonds. This transaction has the effect of (i) defeasing the debt relating to the Series A Mortgage-Backed Bonds from the Company's Consolidated Balance Sheet at December 31, 1984, and (ii) contributing approximately $1.8 million (the difference between the Association's adjusted basis in the securities and their market value at December 31, 1984) of extraordinary gain to the company in 1984.

• • • •

Note K
Extraordinary Items

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In the fourth quarter of 1984 the Company realized an extraordinary gain of $1,767,000 as the result of the defeasance of the Association's Series A Mortgage-Backed Bonds. On December 31, 1984 the Association placed into trust approximately $36 million worth of cash and United States Treasury securities with serial maturity dates matching the Association's interest and principal payment obligations under the Indenture of Trust pursuant to which the Series A Mortgage-Backed Bonds were issued and sold. The difference between the Association's adjusted basis in the bonds and the market value of the securities at December 31, 1984 represents the extraordinary gain.

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GENERAL PUBLIC UTILITIES CORPORATION
Notes to Financial Statements

5. Long-Term Debt

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In December 1984, Met-Ed placed in an irrevocable trust $44.5 million of 10⅞% treasury notes due September 30, 1985. Such notes will satisfy the 9⅝% $45 million series of first mortgage bonds due October 1, 1985, including interest payments to be made on such bonds. Such notes and bonds are not reflected on the December 31, 1984 balance sheet.

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IMPERIAL CORPORATION OF AMERICA
Notes to Financial Statements

6. Retained Earnings and Income Taxes

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Deferred tax expense results from timing differences in the recognition of revenue and expense items for tax and financial statement purposes. The tax effect of these differences is as follows:

	1984	1983	1982
		(000's)	
• • • •			
Gain on defeasance of mortgage-backed bonds deferred for tax purposes	333	—	—
• • • •			

10. Extraordinary Items

Extraordinary items for the year ended December 31,	1984	1983
• • • •		
Gain on defeasance of certain of the company's outstanding mortgage-backed bonds, net of $333,000 of income taxes	796,000	—
• • • •		

Also in December 1984 the company made an irrevocable transfer of U.S. government securities and securities backed by U.S. government obligations to a trust which will make the required interest and principal payments on $34,380,000 of mortgage-backed bonds. Accordingly, the bonds have been considered to be extinguished in an in-substance defeasance.

METROPOLITAN EDISON COMPANY
Notes to Financial Statements

Long-Term Debt and Capital Stock

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(g) In December 1984, the Company placed in an irrevocable trust $44.5 million of 10⅞% treasury notes due September 30, 1985, which will satisfy the 9⅝% $45 million series of first mortgage bonds due October 1, 1985, including interest payments to be made on such bonds. These notes and bonds are not reflected on the December 31, 1984 balance sheet.

MIDWEST ENERGY COMPANY
Notes to Financial Statements

(9) Long-Term Debt:

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On December 28, 1984 IPS defeased the $10,000,000 4¼% First Mortgage bonds due March 1988 by irrevocably placing in trust direct obligations of the United States of America sufficient to satisfy the semi-annual interest payments and the redemption requirements. The Bonds are considered to be extinguished for financial reporting presentation and are excluded from the Consolidated Balance Sheet.

Notes

BANK SOUTH CORPORATION
Notes to Financial Statements

Note 9—Long-Term Debt

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(e) The 9-11% notes payable were issued to finance the construction of a new office on land owned by the Company. During July 1984, the Company extinguished these notes payable by placing in irrevocable trust a sufficient amount of assets to meet the principal and interest requirements of the notes through maturity. Had these notes not been so extinguished, the principal amount outstanding at December 31, 1984, would have been $3,000,000.

THE BLACK AND DECKER MANUFACTURING COMPANY
Notes to Financial Statements

Note 12: Long-Term Debt

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In March 1983, the Company initiated a program to repurchase its 8.45% notes due in January 1985. As of September 1983, approximately $45,300 of these notes had been retired at prices that approximated the net carrying amount of the debt. In September 1983, the Company created an irrevocable trust which acquired certain U.S. Treasury securities for the sole purpose of satisfying its obligation for the payment of principal and interest on the remaining 8.45% notes. Accordingly, as of September 30, 1984 and September 25, 1983, these securities have been offset on the balance sheet against these notes. These transactions had no material impact on earnings.

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COLT INDUSTRIES, INC.
Notes to Financial Statements

4. Long-Term Debt

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c) During 1984, the company repurchased for early retirement $50,703,000 of its 8½% and 9¾% senior promissory notes and defeased the remaining $33,598,000 of 8½% and 9¾% senior promissory notes through the deposit of U.S. Treasury securities with a trustee. The U.S. treasury securities deposited are sufficient to pay the principal and interest on these notes as they become due. At December 31, 1984, the $33,598,000 outstanding balance of defeased notes has been offset against the trusteed funds in the Consolidated Balance Sheet.

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E.I. DU PONT DE NEMOURS AND COMPANY
Notes to Financial Statements

13—Long-Term Borrowings

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In 1984, the company deposited direct U.S. Government obligations in irrevocable trusts to satisfy the scheduled interest and principal payments of $550 in notes due in 1985, 1986 and 1991 (to be called in 1988). These transactions were considered extinguishments of debt for financial accounting and reporting purposes. In addition, during the year, the company purchased $505 of its long-term borrowings. There was essentially no income statement effect from these transactions.

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IDAHO POWER COMPANY
Statements of Changes in Financial Position

	Year Ended December 31,		
	1984	1983	1982
	(Thousands of Dollars)		
• • • •			
Application of Funds:			
• • • •			
Defeasance of Valmy pollution control revenue bonds/notes	53,800	—	—
• • • •			

Notes to Financial Statements

7. Long-Term Debt:

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On June 20, 1984, tax-exempt pollution control revenue notes (commercial paper notes) in principal amount of $53,800,000 were issued by Humboldt County, Nevada. This financing combined the $10,100,000 of bonds issued in December, 1981 due December, 1984, for Valmy Unit No. 1 and the $43,700,000 of notes issued June, 1983 for Valmy Unit No. 2, into one interim financing instrument. On December 20, 1984, Pollution Control Revenue Bonds, Series 1984 due December 1, 2014 in principal amount of $56,200,000 were issued by Humboldt County, Nevada. The proceeds of the bonds were used to provide permanent financing of the Company's share of pollution control facilities for both units at the North Valmy Power Plant by providing funds to retire the $53,800,000 principal amount of notes, to pay a portion of additional qualifying costs of the project and to pay issuance costs in connection with certain previous Valmy pollution control financings. The funds are held by a trustee and are being requisitioned by the Company on a monthly basis. The bonds, backed by a Letter of Credit, were initially issued at the rate of 6.25%, which rate will vary depending upon market conditions. On December 20, 1984, the Company used proceeds from the issuance of the bonds to purchase U.S. Government Securities costing $53,800,000. These securities were deposited in an irrevocable trust to fund the principal and interest payment on the Company's $53,800,000 of tax-exempt pollution control revenue notes due January 17, 1985. As a result of this defeasance transaction the notes and the securities are not included in the balance sheet as of December 31, 1984.

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MERCK & CO., INC.
Notes to Financial Statements

6. Loans Payable and Long-Term Debt

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In 1984, U.S. government securities were deposited in an irrevocable trust, the principal and interest of which will be sufficient to fund the scheduled principal and interest payments on the Company's $200,000,000 of 7⅞% notes which mature on June 15, 1985. As a result of this transaction, the notes were removed from the balance sheet. The resulting gain did not have a significant effect on net income.

PHELPS DODGE CORPORATION
Notes to Financial Statements

10. Long-term Debt and Other Financing

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The proceeds of the preference share issue discussed in Note 13 were used in June 1984 to defease $109 million of the Corporation's 8½% Notes due 1985 by depositing U.S. government securities in an irrevocable trust for the payment in full of interest and principal of this debt. In accordance with the provisions of FAS Statement No. 76, the Corporation considers this debt extinguished for financial reporting purposes. At December 31,1984, the principal amount of this debt was $109 million. Interest and miscellaneous income for 1984 was increased by $3.1 million as the result of the defeasance (Note 5).

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READING & BATES CORPORATION
Notes to Financial Statements

(F) Extraordinary Items

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Debt Extinguishment—In the fourth quarter, the Company retired, at a discount, $45,000,000 of 8¾% Senior Notes and $21,000,000 of 9⅞% Senior Notes due 1993 and 1991, respectively. The retirement was accomplished through redemption and a partial in-substance and legal defeasance. A portion of the debt was redeemed by a cash payment of $52,572,000, including accrued interest of $1,272,000, received from the sale and leaseback of two of the Company's drilling units. In addition, U.S. government securities totalling $10,407,000 were placed in a trust and their use irrevocably restricted to satisfying the remaining principal balances of $7,200,000 on the 8¾% Senior Notes and $3,675,000 on the 9⅞% Senior Notes, and interest payments thereon. The gain less applicable income tax has been accounted for as an extraordinary item in the statement of income as detailed below:

	(in thousands)
Gain on debt extinguishment	$ 3,819
Less applicable income tax	(1,757)
Extraordinary item	$ 2,062
Per common share	$ .08

THE STANLEY WORKS
Notes to Financial Statements

Note E—Long-Term Debt and Credit Arrangements

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During 1984, U.S. government securities costing $5,139,000 were deposited in an irrevocable trust, the principal and interest of which will be sufficient to fund the principal and interest on the balance of $6,000,000 of 4⅞% notes payable. The debt and the government securities were removed from the balance sheet, and the resulting gain of $988,000 is included in Other-net in the Consolidated Statement of Earnings.

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Revolving Credit Agreement

CBI INDUSTRIES INC.
Notes to Financial Statements

7. Long-Term Debt

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On December 28, 1984, CBI deposited $18,000 in an irrevocable trust. These funds were invested in U.S. Treasury Bills maturing on January 4, 1985 to be applied to payments due on the revolving credit agreement on that date; accordingly, long-term debt at December 31, 1984 was reduced by this amount.

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Sinking Fund Debentures

BURLINGTON INDUSTRIES INC.
Notes to Financial Statements

Note F—Long-term Debt

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During fiscal 1984, United States Government securities were purchased at a cost of $10,317,000 and deposited in an irrevocable trust to satisfy scheduled principal and interest payments on $5,000,000 of the 4.75% sinking fund debentures due in 1989 and 1990, $5,720,000 of the 4.125% notes due in 1989 and $4,280,000 of the 4.70% notes due in 1989. The debt issues and government securities were removed from the balance sheet in an in-substance defeasance transaction resulting in a net after-tax gain of $2,316,000 or 8 cents per share. During fiscal 1984, none of this debt was retired by the trustee.

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Note G—Other Income—Net

Other income—net consists of the following (in thousands):

	1984	1983	1982
• • • •			
Gain on in-substance defeasance of long-term debt.............	4,602	—	—
• • • •			

GENERAL MILLS, INC.
Notes to Financial Statements

Note Eight: Long-Term Debt

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In fiscal 1985, we satisfied the future requirements of certain sinking fund debentures through the deposit of U.S. obligations in an irrevocable trust. This transaction increased fiscal 1985 net earnings by $6.7 million ($.15 per share). In fiscal 1984, we satisfied the future requirements of certain sinking fund debentures through the deposit of primarily U.S. obligations in an irrrevocable trust. This transaction increased fiscal 1984 net earnings by $4.0 million ($.09 per share). In fiscal 1983, we exchanged 239,331 shares of our stock held in treasury for $15 million of our sinking fund debentures. This transaction increased fiscal 1983 net earnings by $3.2 million ($.06 per share).

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McGRAW-EDISON COMPANY
Notes to Financial Statements

Note 3 Extraordinary Item

During 1983, the Company retired at a premium $75 million of 13.5% Eurodollar notes due in 1985. In addition, $11.5 million face amount of sinking fund debenture issues was retired through cash purchases. Additionally, $17.1 million face amount of 7.5% Sinking fund debentures, along with a $4.4 million issue of other debt, were removed from the balance sheet through an in-substance defeasance transaction. Net gains from these transactions increased net income $1.7 million or $.10 per share.

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Note 7 Long-Term Debt

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During 1983, the Company removed from the consolidated balance sheet the remaining balance of its 7.5 percent Sinking fund debentures along with an issue of other long-term debt through an in-substance defeasance transaction. To complete the transaction, U.S. government securities were deposited into irrevocable trusts, the principal and interest from which will be sufficient to fund the remaining principal and interest payments on the two debt issues. At December 31, 1984, $20.8 million face amount of the debt issues was outstanding.

Note 17 Quarterly Summary (unaudited)

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During 1983, the Company retired Eurodollar notes, a portion of its sinking fund debentures and completed an in-substance defeasance transaction on two other debt issues. The net (losses) gains from these retirements were reported as extraordinary items.

THE PILLSBURY COMPANY
Notes to Financial Statements

7. Long-term Debt:

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In Fiscal 1985, the Company satisfied the requirements of the 5¾% and 8¾% sinking fund debentures through the deposit of United States Government securities into an irrevocable trust. The effect of these transactions on Fiscal 1985 net earnings was not material.

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APPENDIX

STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 76

Extinguishment of Debt
an Amendment of APB Opinion No. 26

NOVEMBER 1983

Summary

This Statement provides guidance to debtors as to when debt should be considered to be extinguished for financial reporting purposes. This project was undertaken in response to requests to clarify the circumstances that constitute extinguishment and because the Board learned of growing diversity in practice.

This Statement specifies that debt is to be considered extinguished if the debtor is relieved of primary liability for the debt by the creditor and it is probable that the debtor will not be required to make future payments as guarantor of the debt. This Statement also specifies that, even though the creditor does not relieve the debtor of its primary obligation, debt is to be considered extinguished if (a) the debtor irrevocably places cash or other essentially risk-free monetary assets in a trust solely for satisfying that debt and (b) the possibility that the debtor will be required to make further payments is remote. This Statement amends APB Opinion No. 26, *Early Extinguishment of Debt,* to make it apply to all extinguishments of debt, whether early or not, other than those currently exempted from its scope, such as debt conversions and troubled debt restructurings.

This Statement is applicable to transactions occurring after December 31, 1983, with earlier application encouraged in annual financial statements that have not been previously issued. This Statement also permits the restatement of previously issued financial statements to apply this Statement retroactively.

Statement of Financial Accounting Standards No. 76

Extinguishment of Debt

an amendment of APB Opinion No. 26

November 1983

INTRODUCTION AND SCOPE

1. This Statement addresses what shall be considered to be an extinguishment of debt, which in turn affects when the debtor recognizes a gain or loss on extinguishment. This Statement does not address the accounting for redeemable preferred stock. The circumstances for an extinguishment of debt described in paragraphs 3(b) and 3(c) do not apply to debt that is convertible into the debtor's equity securities. Furthermore, the circumstances for an extinguishment of debt described in paragraph 3(c) apply only to debt with specified maturities and fixed payment schedules; consequently, those circumstances do not apply to debt with variable terms that do not permit advance determination of debt service requirements, such as debt with a floating interest rate.

2. Because extinguishment of debt currently is addressed by APB Opinion No. 26, *Early Extinguishment of Debt,* that Opinion is amended to refer to the standards in this Statement for guidance about what shall be considered to be an extinguishment of debt. This Statement also amends that Opinion to make it apply to all extinguishments of debt, whether early or not, other than those currently exempted from its scope, such as debt conversions as described in that Opinion and troubled debt restructurings as described in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings.*

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Circumstances for an Extinguishment of Debt

3. A debtor shall consider debt to be extinguished for financial reporting purposes in the following circumstances:

a. The debtor pays the creditor and is relieved of all its obligations with respect to the debt. This includes the debtor's reacquisition of its outstanding debt securities in the public securities markets, regardless of whether the securities are cancelled or held as so-called treasury bonds.

b. The debtor is legally released[1] from being the primary obligor under the debt either judicially or by the creditor and it is probable[2] that the debtor will not be required to make future payments with respect to that debt under any guarantees.

c. The debtor irrevocably places cash or other assets in a trust to be used solely for satisfying scheduled payments of both interest and principal of a specific obligation and the possibility that the debtor will be required to make future payments with respect to that debt is remote. In this circumstance, debt is extinguished even though the debtor is not legally released from being the primary obligor under the debt obligation.

Restrictions on the Nature of Assets in Trust

4. The following requirements regarding the nature of the assets held by the trust shall be met to effect an extinguishment of debt under paragraph 3(c):

a. The trust shall be restricted to owning only monetary assets[3] that are *essentially risk free* as to the amount, timing, and collection of interest and principal. The monetary assets shall be denominated in the currency in which the debt is payable. For debt denominated in U.S. dollars, essentially risk-free monetary assets shall be limited to:
   (1) Direct obligations of the U.S. government
   (2) Obligations guaranteed by the U.S. government
   (3) Securities that are backed by U.S. government obligations as collateral under an arrangement by which the interest and principal payments on the collateral generally flow immediately through to the holder of the security.

   However, some securities described in the previous sentence can be paid prior to scheduled maturity and so are not essentially risk free as to the *timing* of the collection of interest and principal; thus, they do not qualify for ownership by the trust.

b. The monetary assets held by the trust shall provide cash flows (from interest and maturity of those assets) that approximately coincide, as to timing and amount,

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[1]If nonrecourse debt (such as certain mortgages) is assumed by a third party in conjunction with the sale of an asset that serves as the sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller/debtor for purposes of applying this Statement.

[2]*Probable* is used here, consistent with its use in FASB Statement No. 5, *Accounting for Contingencies,* to mean that it is likely that no payments will be required.

[3]A monetary asset is money or a claim to receive a sum of money that is fixed or determinable without reference to future prices of specific goods or services.

with the scheduled interest and principal payments on the debt that is being extinguished.

Costs Related to Placing Assets in Trust

5. If, in conjunction with placing assets in trust to effect an extinguishment of debt, it is expected that trust assets will be used to pay related costs, such as trustee fees, as well as to satisfy scheduled interest and principal payments of a specific debt, those costs shall be considered in determining the amount of funds required by the trust. On the other hand, if the debtor incurs an obligation to pay any related costs, the debtor shall accrue a liability for those probable future payments in the period that the debt is recognized as extinguished.

Disclosures

6. If debt is considered to be extinguished under the provisions of paragraph 3(c), a general description of the transaction and the amount of debt that is considered extinguished at the end of the period shall be disclosed so long as that debt remains outstanding.

Amendments to Other Pronouncements

7. Paragraph 2 of Opinion 26, which addresses the applicability of that Opinion, is superseded and replaced by the following:

> *Applicability.* This Opinion applies to all extinguishments of debt, whether early or not, except debt that is extinguished through a troubled debt restructuring and debt that is converted to equity securities of the debtor pursuant to conversion privileges provided in terms of the debt at issuance. It supersedes Chapter 15 of ARB No. 43 and paragraph 19 of APB Opinion No. 6. However, it does not alter the accounting for convertible debt securities described in APB Opinion No. 14.

8. Paragraph 3(a) of Opinion 26, which defines *early extinguishment,* is superseded and replaced by the following:

> a. *Extinguishment of debt.* FASB Statement No. 76, *Extinguishment of Debt,* defines transactions that the debtor shall recognize as an extinguishment of debt.

9. The following terms and phrases are deleted from Opinion 26 as indicated:

a. In paragraph 3(c), the term *early*
b. In paragraph 19, the phrase *before scheduled maturities*
c. In paragraph 21, the phrase *before maturity.*

10. The last sentence of footnote 1 of FASB Statement No. 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt,* which refers to AICPA Statement of Position (SOP) 78-5, *Accounting for Advance Refundings of Tax-Exempt Debt,* is superseded and replaced by the following:

> FASB Statement No. 76, *Extinguishment of Debt,* provides criteria for determining whether the advance refunding should be recognized as an extinguishment of the existing debt at the date of the advance refunding.

11. The reference to SOP 78-5, *Accounting for Advance Refundings of Tax-Exempt Debt,* is deleted from Appendix A of FASB Statement No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters.*

Effective Date and Transition

12. This Statement shall be effective for transactions entered into after December 31, 1983. Earlier application of this Statement is encouraged for transactions in fiscal years for which annual financial statements have not previously been issued. Furthermore, retroactive application of this Statement to transactions occurring during fiscal years for which annual financial statements have previously been issued is permitted, in which case the effects on restated per share amounts of prior years shall be disclosed.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of four members of the Financial Accounting Standards Board. Messrs. Kirk, March, and Mosso dissented.

Messrs. Kirk, March, and Mosso dissent from this Statement because they do not believe that extinguishment of debt accounting and resultant gain or loss recognition should be extended to situations wherein the "debtor is not legally released from being the primary obligor under the debt obligation." (Refer to paragraph 3(c).) They believe such accounting should be limited to situations described in paragraphs 3(a) and 3(b), which are more consistent with both present practice and the concept in paragraph 143 of FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises,* that "a liability once incurred by an enterprise remains a liability until it is satisfied in another transaction or other event or circumstance affecting the enterprise." In their opinion, the setting aside of assets in trust does not, in and of itself, constitute either the disposition of assets with potential gain or loss recognition or the satisfaction of a liability with potential gain or loss recognition. Though dedicated to a single purpose, assets in the trust continue to be assets (that is, probable future economic benefits) of the debtor until applied to payment of the debt. Likewise, the liability continues to be a liability of the original debtor until satisfied by payment or by agreement of the creditor that the debtor is no longer the primary obligor. Dedicating the assets might ensure that the debt is serviced in timely fashion, but that event alone just matches up cash flows; it does not satisfy, eliminate, or extinguish the obligation. For a debt to be satisfied, the creditor must be satisfied.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
Victor H. Brown
John W. March
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A

BACKGROUND INFORMATION

Introduction

13. This project was undertaken because the FASB was asked to clarify the circumstances that should cause debt to be considered to be extinguished. Specific inquiries focused on a type of transaction discussed in SOP 78-5. That SOP is one of the AICPA documents from which the FASB is extracting specialized accounting and reporting principles and practices[4] and is issuing them in FASB Statements after appropriate due process, as discussed in Statement 32.

14. SOP 78-5 stipulates that, in an advance refunding,[5] a debtor has extinguished its tax-exempt debt if a legal defeasance[6] of that debt has occurred. The SOP also establishes criteria for determining when a debtor would account for a transaction as an extinguishment of its tax-exempt debt even though legal defeasance of the debt has not occurred. Those transactions, which are described in SOP 78-5 and are referred to as "in-substance defeasance," involve placing assets in trust and irrevocably restricting their use solely to satisfy specific debt. The FASB was specifically asked whether the criteria for "in-substance defeasance" of tax-exempt debt could be used in determining if debt other than tax-exempt debt has been extinguished.

Issuance of Exposure Drafts

15. An Exposure Draft of a proposed Statement, *Extinguishment of Debt and the Offsetting of Restricted Assets against Related Debt,* was issued on October 13, 1982 with a 60-day comment period. The Exposure Draft proposed a new exception to the general principle in paragraph 7 of APB Opinion No. 10, *Omnibus Opinion—1966,* that assets and liabilities should not be offset unless right of setoff exists. The Exposure Draft also proposed that debt be considered to be extinguished only when the debtor's obligation to the creditor has been satisfied, thereby not permitting "in-

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[4]The term *specialized* is used to refer to those accounting and reporting principles and practices in AICPA Guides and SOPs that are neither superseded by nor contained in Accounting Research Bulletins, APB Opinions, FASB Statements, or FASB Interpretations.

[5]SOP 78-5 defines an *advance refunding* as a transaction in which refunding debt is issued to replace refunded debt at a specified future date, with the proceeds placed in trust or otherwise restricted to replacing the refunded debt.

[6]*Defeasance* connotes the debtor's release from legal liability.

substance defeasance" transactions to be accounted for as extinguishments. In addition, the Exposure Draft proposed that debt not be considered to be extinguished if there is any continuing or contingent recourse to the debtor with respect to the debt. The Board received 62 letters of comment in response to the Exposure Draft. Respondents indicated concerns about portions of that Exposure Draft.

16. After considering the comments received, the Board concluded that the Exposure Draft should be revised and reissued for public comment. On July 14, 1983, the Board issued a revised Exposure Draft, *Extinguishment of Debt,* with the following principal changes from the October 1982 Exposure Draft:

a. Debt would be considered extinguished if the debtor is relieved by the creditor from being primarily liable for the debt and is virtually assured that it will not be required to make future payments as guarantor of the debt. Furthermore, even though the creditor does not relieve the debtor of its primary obligation, debt would be considered extinguished if the debtor irrevocably places cash or other assets in a trust to be used solely for satisfying specific debt service requirements of that debt obligation and the debtor is virtually assured that it will not be required to make further payments with respect to the debt that is being recognized as extinguished.
b. No change was proposed to the general principle in Opinion 10 that assets and liabilities should not be offset unless right of setoff exists.

The Board received 75 comment letters on the revised Exposure Draft.

Appendix B

BASIS FOR CONCLUSIONS

17. This appendix discusses the significant comments received on the revised Exposure Draft and the factors deemed significant by members of the Board in reaching the conclusions in this Statement, including alternatives considered and reasons for accepting some and rejecting others. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing. Individual Board members gave greater weight to some factors than to others.

Assumption of Debt by Third Party

18. The Board believes there is a substantive difference between being primarily liable for an obligation and being only secondarily liable for that obligation. Thus, the Board believes that the assumption by a third party of a debtor's obligation to pay a debt and the concurrent agreement by the creditor to look primarily to that third party and only secondarily to the original debtor is an event that affects the original debtor's accounting for that debt. FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises,* states in paragraph 143 that "a liability once incurred by an enterprise remains a liability until it is satisfied in another transaction or other event or circumstance affecting the enterprise." The Board believes that being legally released from being the primary obligor for a debt is "another transaction or other event or circumstance affecting the enterprise" that satisfies a debtor's obligation if it is probable that the debtor will not be required to make future payments with respect to the debt. Concepts Statement 3 also recognizes the substantive difference between being primarily and secondarily liable in paragraphs 136 and 137, which state:

> . . . Most liabilities bind a single enterprise or other entity, and those that bind two or more enterprises or other entities are commonly ranked rather than shared. For example, a primary debtor and guarantor may both be obligated for a debt, but they do not have the same obligation—the guarantor must pay only if the primary debtor defaults and thus has a contingent or secondary obligation, which ranks lower than that of the primary debtor.
>
> . . . The probability that a secondary or lower ranked obligation will actually have to be paid must be assessed to apply the definition [of a liability].

Accordingly, the Board stated in paragraph 3(b) of the revised Exposure Draft that a debtor shall consider debt to be extinguished for financial reporting purposes, even though the creditor has not been paid in full, if the debtor is legally released from being the primary obligor under the debt either judicially or by the creditor and is virtually assured that it will not be required to make future payments with respect to that debt under any guarantees. Although the respondents supported the Board's distinction between being primarily liable for an obligation and being only secondarily liable for that obligation, many felt that paragraph 3(b) posed implementation problems in two respects: (a) use of the term *virtually assured* and (b) requirement for a legal release from the creditor.

Use of the Term *Virtually Assured*

19. Many respondents stated that the revised Exposure Draft's requirement that the debtor be *virtually assured* that it will not be required to make future payments with respect to the debt imposes too high a level of confidence when applied to debt assumptions, particularly real estate transactions. Because the debtor legally has only a contingent liability, the accounting for which is addressed by FASB Statement No. 5, *Accounting for Contingencies,* respondents generally suggested that the term *virtually assured* be replaced by the term *probable* as used in Statement 5. The Board concurs with those respondents and has changed paragraph 3(b) accordingly.

Requirement for a Legal Release from the Creditor

20. Some respondents thought the requirement in paragraph 3(b) for a legal release from the creditor was too strict and would change current practice for some real estate transactions. They suggested that debt be considered extinguished whenever a "debt assumption" gives the debtor assurance that it will not be required to make future payments, even though the debtor is not legally released from being the primary obligor under the debt obligation. The Board decided to retain the requirement for a legal release in paragraph 3(b) because that subparagraph focuses on the important distinction between being primarily liable for an obligation and being only secondarily liable for that obligation. The Board specifies in paragraphs 3(c) and 4 the conditions for an extinguishment when the debtor continues to be legally liable as the primary obligor. The Board believes third party debt "assumptions" without a legal release from the primary obligation effectively create for the debtor a receivable from the third party for the payments expected to be made by that party on the debtor's behalf.

21. Some respondents asked whether a legal release by the creditor is necessary for the extinguishment of nonrecourse debt that is assumed in conjunction with the sale

of assets that serve as sole collateral for that debt. The Board believes that such a sale and related assumption effectively accomplish a "legal release" for the seller/debtor and has added a footnote to paragraph 3(b) to clarify that point.

In-Substance Defeasance and Extinguishment of Debt

22. The Board believes that, in general, recognizing the effect of in-substance defeasance transactions as extinguishing debt is reasonable because settlement in cash is not always feasible and the effect of an in-substance defeasance is essentially the same. Accordingly, the Board believes that, in certain circumstances, debt should be considered extinguished for financial reporting purposes even though the debtor is not legally released from being the primary obligor under the debt obligation. In the July 1983 revised Exposure Draft, the Board proposed in paragraph 3(c) that debt be considered extinguished if the debtor irrevocably places cash or other assets in a trust to be used solely for satisfying specific debt service requirements of a debt obligation and the debtor is virtually assured that it would not be required to make future payments with respect to that debt, even though the debtor was not legally released from being the primary obligor under the debt obligation. The revised Exposure Draft also would have imposed certain restrictions in paragraph 4 regarding the nature of the assets held by the trust to reinforce the high threshold imposed by the Board for recognizing an extinguishment of debt when the debtor remains the primary obligor.

23. Most respondents supported the concept that an in-substance defeasance is an extinguishment of debt for financial reporting purposes, although some respondents suggested changes to the revised Exposure Draft. Many respondents commented about (a) the requirement in paragraph 3(c) that the debtor be *virtually assured* and (b) the requirement in paragraph 4 that the trust assets be *essentially risk free.*

Use of the Term *Virtually Assured*

24. The respondents' most frequent concern was about the use of the term *virtually assured.* Some perceived the term as requiring a level of confidence so near absolute certainty as to be unworkable—a level that goes beyond the intent of the conceptual framework. Others objected to use of the term because it was undefined and no substantive guidance was provided to apply it. Still other respondents were concerned because they saw no need for a new term. Many respondents recommended that the Board use terms that are used in other accounting standards, such as *probable* and *remote* as defined in Statement 5.

25. The Board agreed that use of a new term is unnecessary and changed paragraph 3(c) to use the term *remote.* In doing so, the Board does not intend to lower the high

threshold of this Statement for in-substance defeasance transactions; the term *remote* establishes a high test and the trust assets are still required by paragraph 4 to be essentially risk free.

26. As discussed above, paragraph 3(c) of this Statement now requires that the possibility be remote that the debtor will be required to make future payments with respect to the debt. That requires an assessment of the circumstances at the date of the in-substance defeasance transaction regarding the likelihood of the debtor's being required to make such future payments. A requirement for such future payments by the debtor could arise due to an inadequacy of trust assets attributable not only to a failure to realize scheduled cash flows from trust assets but also to an acceleration of the debt's maturity due to a violation of a covenant of the debt issue being extinguished or, if cross-default provisions exist, of a covenant of another debt issue.

27. The Board believes that a debtor's placing assets irrevocably in a trust to be used solely to pay the debtor's obligation is "another transaction or other event or circumstance affecting the enterprise" (refer to paragraph 18 of this Statement) that effectively satisfies a debtor's obligation if the possibility is remote that the debtor will be required to make further payments with respect to the debt that is being recognized as extinguished. The Board believes that such an arrangement ensures that the debtor has no "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events," the definition of a liability in paragraph 28 of Concepts Statement 3 (footnote references omitted). Thus, the Board believes that the debtor should remove the liability for the debt from its balance sheet.

Requirement That Assets Be Essentially Risk Free

28. The revised Exposure Draft stipulated two requirements that the assets placed in trust in an in-substance defeasance had to meet:

a. They are monetary assets that are *essentially risk free* as to collection of interest and principal.
b. Their maturities do not extend beyond the maturity of the debt that is being extinguished.

Those requirements were intended to eliminate nearly all risk that the trust would not have funds available to meet the scheduled interest and principal repayments on the defeased debt.

29. Most respondents requested further guidance about what assets should be considered essentially risk free. Some respondents considered investments in direct obligations of the U.S. government as the only monetary assets that could be considered essentially risk free because they alone were cited as an example. Some respondents disputed the Board's view that an investment in highly rated corporate securities should not be considered to be essentially risk free as to collection of interest and principal. A few respondents asked whether trust assets also had to be risk free with respect to the timing of the collection of principal and interest.

30. The Board believes the concept of in-substance defeasance requires trust assets to be risk free not only with respect to the collection of principal and interest but also with respect to the timing of those collections. Paragraph 4(a) clarifies that point.

31. Although it would prefer to provide only broad guidance as to what monetary assets are to be considered essentially risk free under paragraph 4, the Board decided that specific guidance is needed to preserve the high threshold it considers necessary for in-substance defeasance transactions. Accordingly, the Board stipulated that, for debt denominated in U.S. dollars, essentially risk-free assets shall be limited to direct obligations of the U.S. government, obligations guaranteed by the U.S. government, and securities collateralized by U.S. government obligations, provided such monetary assets are essentially risk free as to both the collection of interest and principal and the timing of such collections. The Board believes that securities that are backed by U.S. government obligations as collateral should be considered essentially risk free as to the timing of the collection of interest and principal only if an arrangement exists in which the interest and principal payments on the collateral generally flow immediately through to the holder of the security, for example, as in a closed trust.

32. Several respondents asked the Board to provide guidance regarding the in-substance defeasance of debt denominated in foreign currencies and whether the trust can use forward contracts to protect against exchange rate changes if only U.S. government obligations qualify for trust assets. The Board concluded that neither U.S. government obligations nor such forward contracts would be essentially risk-free monetary assets to defease debt denominated in foreign currencies. Consequently, paragraph 4(a) requires that the trust invest only in monetary assets that are denominated in the currency in which the debt is payable. The level of assurance with respect to the collection of interest and principal, and the timing of such collections, from monetary assets denominated in foreign currencies should be equivalent to that required for the in-substance defeasance of debt denominated in U.S. dollars.

33. Some respondents questioned the accounting for reacquiring in the marketplace debt that has previously been extinguished due to an in-substance defeasance, specif-

ically whether further gain or loss could be recognized. The Board believes that, if a debtor purchases its own debt securities that have previously been recognized as extinguished in an in-substance defeasance, the debtor is making an investment in the future cash flows from the trust and should report its investment as an asset in its balance sheet. The debtor should not be considered to be reextinguishing its debt. Thus, no gain or loss should be recognized from such purchase of those debt securities.

The Need for Matching Maturities and the Effect of Reinvestment Earnings

34. Inherent in the concept of in-substance defeasance is the matching of the trust's cash inflows from its investments with its cash outflows for paying periodic interest payments and principal repayment. The Board believes that matching of assured inflows with scheduled outflows is important so that the trust is not exposed to any risk on reinvesting premature inflows. SOP 78-5 recognized the importance of matching cash flows and required that "the funds used to consummate the advance refunding [be] invested in qualifying securities with maturities that approximate the debt service requirements of the trust." As a surrogate for requiring the matching of trust inflows and outflows, the revised Exposure Draft (a) required that the monetary assets held by the trust have maturities not extending beyond the maturity of the debt being extinguished and (b) excluded from the defeasance computation any earnings from the reinvestment of the scheduled net inflows from maturity of the trust's initial investments. That exclusion was intended to preclude significant mismatching of cash flows. Some respondents incorrectly interpreted the exclusion of reinvestment earnings as a prohibition against compounding interest.

35. The Board has decided to address more directly the need for matching the trust's cash flows. Consequently, paragraph 4(b) requires that the monetary assets held by the trust provide cash flows (from interest and maturity) that approximately coincide, as to timing and amount, with the scheduled interest and principal payments on the debt that is being extinguished. That requirement will serve to minimize significant reinvestment earnings.

Partial Defeasances

36. Some respondents asked whether the in-substance defeasance of only a portion of the obligations under a debt issue was permitted by the revised Exposure Draft. Although in-substance defeasance transactions have typically, as the Board understands, comprehended an entire debt issue, the Board believes that conceptually there is no impediment to a partial in-substance defeasance. In a partial in-substance defeasance, the debt considered extinguished will be either (a) a pro rata portion of

all remaining interest and principal repayment obligations of the debt issue or (b) the principal and interest payments for a specific debt instrument (such as a serial bond with a specific scheduled maturity). Thus, the debtor cannot recognize a partial defeasance of the obligation for only the interest payments or for only the principal repayment.

Applicability

37. Several respondents asked whether the revised Exposure Draft permits the in-substance defeasance of convertible debentures, debt with floating interest rates, and capitalized lease obligations. Respondents also asked whether the document was intended to apply to preferred stock with mandatory redemptions provisions. The Board has concluded that the provisions for an extinguishment in paragraphs 3(b) and 3(c) do not apply to convertible debentures due to the inseparability of the debt and the conversion option and to the fact that there will be no obligation to pay if the debentures are converted. The Board decided that the circumstances for an extinguishment of debt described in paragraph 3(c) apply only to debt with specified maturities and fixed payment schedules; consequently, the provisions for in-substance defeasance in paragraph 3(c) do not apply to debt with floating interest rates because of the uncertainty of the future debt service requirements. However, the provisions for in-substance defeasance generally apply to capitalized lease obligations if the lease obligation has a specified maturity and a fixed payment schedule. The Statement does not apply to preferred stock with mandatory redemption provisions because the Board has not addressed whether such preferred stock should be accounted for as debt.

38. Consistent with Opinion 26, this Statement does not address extinguishment through conversion of debt by exchange for equity securities of the debtor pursuant to conversion privileges provided in the terms of the debt at issuance. In addition, this Statement amends Opinion 26 to apply to an extinguishment of debt whether or not the extinguishment was early, consistent with FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt,* which also applies to all debt extinguishments. The Board understands that extinguishments at scheduled maturity would seldom involve gain or loss under Opinion 26.

Disclosure Requirements

39. Some respondents opposed the requirement in the revised Exposure Draft to continue disclosing in the financial statements of subsequent periods information about debt that had been extinguished in a defeasance transaction until that specific debt issue no longer remained outstanding. Those respondents considered the con-

tinuing disclosures to be unnecessary, particularly since Statement 5 addresses disclosures for contingencies. Those respondents also considered the continuing disclosures to contradict the substance of the transaction and to raise doubt about the propriety of recognizing an extinguishment. The Board believes that, because an outstanding defeased debt issue is not reported in the balance sheet, continuing disclosures are needed in the notes to provide useful information to the creditors and investors about that debt issue. Accordingly, the requirement was retained.

Offsetting Assets against Liabilities

40. Several respondents to the revised Exposure Draft commented about offsetting assets against liabilities, though it was apparent that some respondents had confused *offsetting* with *extinguishment*. In the Board's view, *offsetting* is a display issue—how recognized assets and recognized liabilities should be presented in a balance sheet (or how other recognized elements should be displayed in a basic financial statement). In contrast, *extinguishment* is a recognition issue—whether an asset or a liability exists and whether continued recognition is warranted in the basic financial statements. This Statement addresses when debt ceases to be a liability that warrants continued recognition in the balance sheet.

41. The Board has concluded that there is no need to create an additional exception to the general principle in Opinion 10 that the offsetting of assets and liabilities in the balance sheet is improper except if a right of setoff exists.

AICPA Statement of Position 78-5 and Extinguishment of Tax-Exempt Debt

42. The Board considered whether SOP 78-5 contains specialized accounting and reporting principles and practices that warrant extraction and issuance in an FASB Statement, as discussed in paragraph 13. "In-substance defeasance" transactions that have been accounted for as extinguishments under SOP 78-5 generally will continue to be accounted for as extinguishments under this Statement; thus, the related provisions of the SOP are no longer "specialized." Other provisions of the SOP relate to accounting by state and local governmental units and are not being extracted pending resolution of the FASB's involvement with standard setting for those entities. (Refer to paragraph 8 of Statement 32.) The Board believes the remainder of SOP 78-5 consists of descriptions and examples of refunding transactions that are not specialized accounting and reporting principles; thus, extraction is not warranted. Accordingly, this Statement deletes the reference to SOP 78-5 from Appendix A of Statement 32.

Amendment to Statement 22

43. Statement 22 addresses changes to lease agreements resulting from refundings of tax-exempt debt and specifies different accounting depending on whether the refunding is accounted for as an extinguishment. Footnote 1 of that Statement refers to SOP 78-5 for "descriptions of advance refundings that are and are not accounted for as early extinguishments of debt." This Statement amends Statement 22 to replace the footnote reference to SOP 78-5 with a reference to this Statement.

Effective Date and Transition

44. Several respondents suggested that the final Statement should permit, but not require, retroactive implementation and restatement of previously issued financial statements for transactions occurring in years previously reported so that similar transactions can be reported similarly. The Board concurs in that recommendation and has modified the Statement accordingly.

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